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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 21

UNITED STATES, PETITIONER

v.

DON GILMORE AND SUE GILMORE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES ON REARGUMENT[1]

OPINION BELOW

The opinion of the Court of Claims is reported at 290 F. 2d 942.

JURISDICTION

The judgment of the Court of Claims was entered on June 7, 1961. (R. 112, 125.) The petition for a writ of certiorari was filed on July 25, 1961, and was granted on October 9, 1961. (R. 145, 368 U.S. 816.) The case (No. 255, 1961 Term) was argued on March 27–28, 1962, and by order of April 2, 1962, was restored to the calendar for reargument (369 U.S. 835).

[1] This brief and the separate brief being filed in *United States* v. *Patrick*, No. 22, replace the joint brief filed in the two cases in the 1961 term (Nos. 255 and 256).

The jurisdiction of this Court rests on 28 U.S.C. 1255 (1).

QUESTION PRESENTED

Whether the following expenses incurred by a husband in divorce litigation qualify as "ordinary and necessary expenses" incurred "for the management, conservation, or maintenance of property held for the production of income" so as to be deductible under § 23(a)(2) of the Internal Revenue Code of 1939, or are nondeductible "personal" or "capital" expenditures:

(1) the expenses of resisting his wife's claim that an income-producing asset was in part community property;

(2) the expenses of resisting his wife's claim that, because of his personal misconduct, she should be given some of his half of the income-producing asset if it was community property; and

(3) the expenses of answering charges of personal misconduct to avoid adverse publicity that might cause harm to his income-producing capacity.

STATUTES AND REGULATIONS INVOLVED

Sections 23, 24, and 113, Internal Revenue Code of 1939; §§ 162, 212, 262, and 1016, Internal Revenue Code of 1954; § 146 of the California Civil Code; §§ 39.23(a)-15, 39.24(a)-1, and 39.24(a)-2, Treasury Regulations 118 (1939 Code); §§ 1.212-1, 1.262-1, and 1.263(a)-2, Treasury Regulations on Income Tax (1954 Code), are found in the Appendix, *infra*.

STATEMENT

The respondent[2] and Dixie Gilmore were married in 1946. Six years later, in 1952, they began divorce proceedings against each other in the California courts. At the time of the divorce proceedings, the respondent's property consisted primarily of controlling stock interests (varying from 60% to 100%) in three corporations, each of which was a franchised General Motors automobile dealer.[3] As president and managing officer of the three corporations he received annual salaries totaling $66,800 a year; his dividends had in recent years averaged $83,000; and his total annual income from the corporations was thus approximately $150,000 (R. 128). His income from other sources was negligible (R. 128). Because the divorce proceedings threatened in various ways the respondent's interest in the corporations, his sole source of income, the Court of Claims held that 80% of the costs of conducting the divorce litigation could be deducted as "ordinary and necessary expenses paid or incurred * * * for the management, conservation, or maintenance of property held for the production of income," within the meaning of § 23(a)(2) of the Internal Revenue Code of 1939.

The facts are not in dispute. An analytical statement of them, drawn from the reported decisions in the

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[2] Don Gilmore will be referred to as the sole respondent. His present wife is a party only because a joint return was filed in 1955. Dixie Gilmore, his former wife, and a party to the divorce proceedings, will be referred to as respondent's "wife" notwithstanding the divorce.

[3] Don Gilmore-San Francisco (of which respondent owned 100%) and Don Gilmore-Hayward (73⅓%) were Chevrolet agencies; Don Gilmore-Riverside (60%), a Pontiac agency.

State proceedings (*Gilmore* v. *Gilmore*, 282 P. 2d 598, reversed, 45 Cal. 2d 142, 287 P. 2d 769) as well as from the record, follows.

A. THE DIVORCE PROCEEDINGS

1. In terms of the judicial relief sought by the parties, there were four major issues in the divorce proceedings:

First, to whom the divorce was to be granted. The wife prayed for a divorce on the ground of the respondent's extreme cruelty and adultery. The respondent prayed for a divorce on the ground of her extreme cruelty (R. 132).

Second, whether the wife was entitled to alimony. That depended upon whether he or she was awarded the divorce (R. 133, 282 P. 2d at 606).

Third, how the community property was to be divided (R. 132). Whichever party was awarded the divorce was entitled to be given more than half and up to all of the community property, as the court "may deem just."[4]

Fourth, whether there was any community property. The stock of the corporations was originally the respondent's separate property. During the marriage, however, the corporations had retained out of current earnings some $600,000, increasing their

[4] Cal. Civ. Code § 146, applicable to divorces, as here, based on extreme cruelty or adultery. See *Barham* v. *Barham*, 33 Cal. 2d 416, 202 P. 2d 289; *Wilson* v. *Wilson*, 159 Cal. App. 2d 330, 323 P. 2d 1017.

net worth from $182,010.46 to $786,045.52. The wife contended that those retained earnings were attributable to the respondent's personal services and thus impressed with a community interest, making the stock itself community property to the extent that it represented those retained earnings. Respondent contended that he had been adequately paid for his services and that the earnings retained were attributable rather to the capital assets of the corporations. (R. 130, 131, 133, 134.)

Of the four issues, the first three (divorce, alimony, and division of community property) all turned upon a common fact—which party was the wronged one entitled to the divorce. The fourth issue (the existence of community property) was, in contrast, entirely separate from the rest of the litigation.

2. The trial of the divorce suit took 24 trial days and filled over 3,000 pages of transcript (R. 131). The major part of the protracted trial (about 5/6, measured by the pages of the transcript devoted to the subject) was devoted to proof and disproof of charges and countercharges of adultery, alcoholism,

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[1] See 45 Cal. 2d 142, 149, 287 P. 2d 769, 773-774. In the case of the two corporations not wholly-owned, the figures include only the percentage of the net worth allocable to the respondent's share of the stock. Presumably because of that adjustment, the Court of Claims' findings speak, somewhat imprecisely, of the $600,000 increase as an increase in the "value" of the respondent's "stockholdings." See R. 130 and compare R. 131 (Finding 22). In any event, the record of the state proceedings (part of the record in this case) makes clear that the figures represent changes in the corporations' net worth resulting from increases in their earned surplus accounts. (See Exhibit P-6, pp. 1886-1887.)

abnormal sex acts, physical and verbal abuse, and the like, all of which led the intermediate appellate court to describe the trial as "one of the most sordid and revolting with which" any court had been required to deal. 282 P. 2d 598, 599. A much smaller part of the trial was devoted to the proof of the facts relevant to the existence of community property (adequacy of the salaries paid the respondent; amounts expended by him for community purposes; etc.) (R. 132).

The outcome of the trial was a complete victory for the respondent. His wife was denied a divorce and he was granted one; there was found to be no community property; and an award of $9,000 a year alimony to the wife was vacated on motion of respondent on the ground that the denial of a divorce to her precluded an alimony award. (R. 29–30, 108–109.)

3. On the wife's appeal, the District Court of Appeals reversed the judgment and directed a new trial on the ground that the trial court had given inadequate weight to the respondent's proven adultery as a basis for awarding a divorce also to the wife and thereby permitting an award of alimony. 282 P. 2d 598. On the respondent's appeal to the California Supreme Court, however, that court reinstated the judgment, holding that the trial court did not abuse its discretion in discounting the importance of the respondent's post-complaint adultery. It also affirmed the finding that there was no community property in the stock. 45 Cal. 2d 142; 287 P. 2d 769. The final result of the litigation, therefore, was that the respondent was awarded the divorce and his wife took nothing.

B. THE PROCEEDINGS BELOW

For the costs of the divorce litigation (attorneys' fees, records, printing, etc.), the respondent had spent $32,537 in 1953 and $8,074 in 1954.[6] In a suit for refund brought in due course, the Court of Claims upheld the respondent's claimed deduction of 80% of those expenditures as expenses of "conserving" income-producing property under § 23(a)(2) of the 1939 Code (R. 4–6).[7]

Of the four issues in the divorce proceeding previously outlined, the court treated as nondeductible the expense of the first two (divorce and alimony) and as deductible the expense of the latter two (division and existence of community property) (R. 117–118, 132, 136–137). In addition, the court treated as an additional basis for deduction a fifth non-legal objective found to have been pursued in the divorce proceeding—namely, the purpose, in defending against the charges of scandalous behavior made against him, to minimize the damage to his reputation and the risk that General Motors might cancel his corporations' franchises because of the adverse publicity (R. 118, 132–133). Thus, the court held deductible in principle the expenses attributable to:

> (a) establishing that no part of the stock was community property;

---

[6] (R. 134–135). He spent an additional $5,300 in 1955 (R. 114), but that year is not involved here.

[7] The second year involved is governed by the 1954 Code (§ 212(2)), but for simplicity we will refer only to the 1939 Code.

(b) establishing his right, and defeating his wife's, to more than half of whatever community property there was; and

(c) protecting his reputation with General Motors against charges of personal misconduct.

The first of those objects involved a separable part of the litigation and the expenses of accomplishing it could in theory be separately identified. The others, however, were but two consequences that flowed from the same litigation effort—establishing the innocence of the respondent and the guilt of his wife—that also produced the consequences of the divorce being awarded to the respondent and his wife being denied alimony. The problem of allocating a single expenditure (that of litigating the misconduct issues) among four different consequences produced by it was solved by relying upon the testimony of the respondent and his attorneys that the divorce and alimony consequences were not in themselves considered important and that the misconduct issues would not have been so vigorously fought, at so great an expense, but for their impact upon the division of community property and upon the respondent's reputation (R. 118, 130, 133; see R. 25–26, 30, 33–34, 63, 77–80, 86–90). It was on that basis that 80% of the total costs—*i.e.*, not only the separable expenses of disproving the existence of community property but also the major part of the expenses of litigating the misconduct charges—was allocated to the deductible items.

SUMMARY OF ARGUMENT

We do not challenge the Court of Claims allocation of the expenses and we concede that the sole reason why the respondent incurred the expenses for which

a deduction was allowed was to prevent the loss of his stock and possibly of his job. Our argument is rather that the deductibility of the expense of resisting a financial demand (passing for the moment the community property aspects of the case) turns solely upon the source and nature of the claim and not upon the threatened consequences of its assertion.

I

A. Section 23(a)(2) allows a deduction for all the "ordinary and necessary expenses paid or incurred * * * for the management, conservation, or maintenance of property held for the production of income." While successfully resisting a monetary liability avoids the need to sell property to raise money to satisfy the liability, the costs of the litigation do not for that reason become expenses of the "conservation" of "property" no matter how literally the statute is read. The statute speaks of conserving "property," not the taxpayer's *interest in* the property, and the use of "conservation" in association with "management" and "maintenance" confirms that "conservation * * * of property" was used in the sense of a physical safeguarding of the thing itself and not in the sense of "conserving" one's "estate" by minimizing one's liabilities. And even if the expenditures did literally fit the wording of § 23(a)(2), they would still be disallowed by § 24(a)(1) if deemed to be "personal" or "family" expenses. Even on the most literal approach to the statute, therefore, it becomes necessary to leave the wording of § 23(a)(2) and search for the underlying distinction between "business" and "personal" expenses.

B. That the dichotomy between "business" and "personal" remains is confirmed by the history of § 23(a)(2). The statute originally allowed deductions only for the expenses of carrying on a "trade or business" (now, § 23(a)(1)). The expenses of other income-producing activities which were held not to constitute a "trade or business"—such as the expense of maintaining a staffed office to handle the taxpayer's investments in securities—were not deductible. Section 23(a)(2) was added specifically to remove the "trade or business" limitation and permit deduction of the expenses of all income-producing activities. The committee reports, as this Court has repeatedly recognized, make plain that that was the sole purpose of § 23(a)(2). Thus, all that § 23(a)(2) establishes for this case is that the expenses of respondent's holding of stock for the production of dividend income are deductible (as they would not have been before § 23(a)(2)). It does not go to the question—the only issue here—whether a particular expenditure qualifies as an expense "of" his stock-holding or, to the contrary, is an expense "of" his marriage or his personal life. In brief, § 23(a)(2) removes the distinction between a "trade or business" and other kinds of income-producing activities—so that the expenses of all kinds of income-producing activities can now conveniently be described as "business" expenses—but it does not remove the distinction between "business" expenses and "personal" expenses.

II

A. The characterization as "personal" or "business" of the costs of resisting a claim is governed

by the source and nature of the claim and not by the consequences its successful assertion would have. Thus the deductibility of the costs of defending a personal injury suit turns upon whether the accident occurred in the course of business or of personal activities, not upon whether the wealth of the defendant at the time of the suit happens to be invested in income-producing or non-income-producing assets. Since the nature of the assets the defendant holds when sued (and hence those "threatened" by the suit) has nothing to do either with the cause of the suit or the reasons for defending it (there is as much cause to defend whether a store or a home is at stake), it would be wholly capricious to make the nature of the assets then held determinative of the tax consequences, particularly when it is recognized that wealth is readily convertible from one form to another and whether it is in income-producing or non-income-producing form at the date of the trial depends entirely upon the preferences of the defendant.

B. That the source rather than the consequence of the claim controls is, moreover, conclusively established by the decisions of this Court in *Kornhauser* v. *United States,* 276 U.S. 145, and *Lykes* v. *United States,* 343 U.S. 118. In *Kornhauser,* the Court held that defense of a claim arising out of a business transaction was a "business" expense notwithstanding that, at the time of the suit, the defendant was no longer in the business and the claim threatened only non-business property. *Lykes* applied the same principle to the converse situation (that present here), holding that the defense of a claim arising from a

personal transaction (a gift, giving rise to a claim for gift taxes), is a nondeductible "personal" expense notwithstanding that the claim, undefended, would have consumed the taxpayer's income-producing property.

C. Although the lower court decisions relied upon by the Court of Claims, beginning with the Eighth Circuit's decision in *Baer* v. *Commissioner*, 196 F. 2d 646, purport to recognize the basic principle of the *Lykes* case and to create only an "exception" to it, there is no rational basis for the exception. Its scope, so far as its boundaries can be perceived, seems to extend to any case in which, because of the nature of the husband's holdings, the wife's demands threaten the loss not only of his property but also of his job (as by loss of a controlling stock interest). Apart from its lack of any justifying rationale, that "exception"—giving to persons who own substantial blocks of stock in corporations of which they are officers a right to a deduction for divorce litigation costs that is denied to all other taxpayers—is affirmatively offensive in creating the very kind of discrimination among taxpayers that was condemned by this Court in *Lykes*.

III

The application of those principles to this case is complicated by the circumstance, though not relied upon by the Court of Claims, that the dispute involved claims to community property. As to the bulk of the expenses for which a deduction was allowed, however, that is not a relevant difference, and the

treatment of the small part remaining—turning peculiarly upon the effect to be given to community property concepts—can properly be left for resolution by the Court of Claims on remand.

A. The larger part of the costs for which a deduction was allowed was incurred in the course of litigating, in the divorce court, the parties' charges and countercharges of misconduct of the most intimately personal nature. The theory on which those expenses were allowed was that, while the proof and disproof of misconduct went immediately to determine which party got the divorce and the wife's right to alimony (not claimed as objectives warranting deduction), it also went indirectly, and more importantly, to the disposition of any community property found to exist. Under California law, if a divorce is awarded for adultery or extreme cruelty, the court can give to the innocent spouse so much of the guilty spouse's half of the community property as it deems just. There was thus involved in the litigation (1) the wife's claim to be given some of the respondent's half of the community property because of his mistreatment of her and (2) the respondent's counterclaim, as it were, to be given some of his wife's half because of her mistreatment of him. It was as a cost of defending and prosecuting those claims that the costs of litigating the misconduct charges were held deductible.

The opposing claims for an unequal division of community involved, it is apparent, not "property" rights, but the claim of the innocent spouse to be

given part of the wrongdoing spouse's property as a remedy for a wrong done to his or her person. Those claims are thus no different, in any respect relevant here, from a tort claim for an injury to the person or the inchoate rights of a wife in a common law state to be given a part of the husband's property for her maintenance and support. The claims having their source in the personal conduct of the parties, the expenses of defending or prosecuting them are equally personal and hence nondeductible.

B. The remaining costs for which a deduction was allowed, a small part of the total, were incurred in litigating the *existence* of community property—specifically, in defeating the wife's claim that some part of the stock had become community property because of the alleged retention by the corporations of earnings attributable to the respondent's personal services. Since that dispute involves an assertion of existing "property" rights in specific assets, complicated by the peculiarities of the community-property system, the treatment of that part of the costs raises a variety of problems quite different from those involved in the basic question the case was brought here to resolve. Nor were these questions separately considered by the Court of Claims, which disposed of the whole case rather on the broad grounds discussed above. In the circumstances, should the Court agree with us on the main question and hence as to the necessity of reversing the judgment at least as to the expenses of litigating the misconduct issue, the proper course would be to remand the case to the Courts of Claims to allow that court to consider in the first instance

the proper treatment of the costs specifically attributable to the community-property contest.

ARGUMENT

INTRODUCTION

During 1953 and 1954, the respondent expended some $40,600 for attorneys' fees and other costs in divorce litigation with his wife. The Court of Claims allocated 80% of those costs, or $32,500, as the costs of (a) establishing that there was no community property; (b) establishing the respondent's right to more than half of the property, if it was community property; and (c) protecting his reputation against his wife's charges. We do not challenge that allocation and, to make the identification of costs with objects more concrete, are willing to assume that the other issues (marital status and alimony) had somehow been entirely eliminated from the litigation. To remove any remaining factual ambiguities, moreover, we are willing to accept also the following as the facts: that the stock in the three corporations was the only property owned by respondent and hence the only property out of which any award to his wife could be satisfied; that the wife could and would have insisted upon an immediate lump-sum payment of any award to her and that respondent could not have financed the payment by any means other than an outright disposition of the stock (either by giving it in kind to his wife or by selling it to raise the cash); that the disposition of a substantial part of his stock, either to his wife or to third parties, would have caused respondent to lose his position as president of the corporations and might have

caused General Motors to cancel the corporations' franchises; that the scandalous charges made by his wife created a risk that General Motors would cancel the franchises because of the damage to respondent's reputation; and that respondent had no concern for his reputation except as it affected his business interests. The purpose of these concessions is to establish beyond doubt, and we so stipulate, that the sole reason why respondent spent the $32,500 was to keep his stock, his corporations' franchises, and his job.

To the extent, therefore, that the words imply merely a fact, we acknowledge that there was a direct and immediate relationship between the expenses and the retention of income-producing property (the stock) and of an income-producing capacity (the job), for that was indeed the sole reason why the expenses were incurred. The question we propose to argue is not whether that relationship existed (it did) or how "direct" it was (it was direct indeed), but whether that relationship is the legally relevant one. What we will show is that the deductibility of litigation costs turns, not upon the consequences a failure to defeat the claim would have, but upon the origin or nature of the claim itself. We will then show that, looking to the source and nature of the claims asserted by Mrs. Gilmore here, the expenses of resisting them must be characterized primarily as nondeductible "personal" expenses and perhaps in part as capital expenditures.

Although the State litigation in this case actually involved a community-property contest, the Court of Claims' decision does not turn on that circumstance

but applies principles equally applicable to, and in fact derived from cases involving, the costs of resisting a wife's financial demands in a common-law jurisdiction. It was presumably because of the conflicts over those principles, and not the community-property aspects of this case, that certiorari was granted. For that reason and in order to cast the discussion in terms equally applicable to the companion case (*United States* v. *Patrick*, No. 22), which does not involve community property, the argument in Points I and II of this brief will ignore the community property aspect of the case and treat the case, as did the Court of Claims, as though the wife had asserted, not a "property" right, but merely an *in personam* liability of the husband. We will then in Point III consider the problems peculiar to the community-property aspects of the case.

I.

A LITERAL READING OF SECTION 23(a)(2) WOULD NOT ENTITLE RESPONDENT TO A DEDUCTION AND THE QUESTION TURNS INSTEAD UPON THE BASIC DICHOTOMY BETWEEN "BUSINESS" AND "PERSONAL" EXPENSES

Section 23(a) of the 1939 Code allows a deduction from gross income for all "the ordinary and necessary expenses paid or incurred":

> (1) * * * in carrying on any trade or business * * *.
>
> (2) * * * for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

Section 24(a)(1) adds the qualification that:

> * * * no deduction shall in any case be allowed in respect of—
>
> (1) Personal living, or family expenses * * *.

Respondent claims that his litigation costs are deductible as an expense of his holding of stock for the production of dividend income. To establish the right to deduction, he must show two things: (1) that stock-holding is an activity the expenses of which are deductible; and (2) that the litigation costs are properly to be treated as an expense "of" that income-producing activity rather than "of" his personal life. When § 23(a)(2) stood alone, respondent could not have met the first requirement, for the mere holding of securities, although an income-producing activity, is not a "trade or business." Section 23(a)(2), however, overcame that obstacle by making the expenses of all income-producing activities, including mere property-holding, deductible whether or not they constitute a "trade or business." We will show that that was all that § 23(a)(2) was meant to do and that it was not intended to create a new and different standard for answering the second question—namely, whether a particular expenditure constitutes an expense of the income-producing activity or of the taxpayer's personal life. In short, we will show that § 23(a)(2) removed the distinction between a technical "trade or business" and other income-producing activities—so that the expenses of

either can now conveniently be described as "business" expenses—but it did not remove the dichotomy between "business" expenses and "personal" expenses or prescribe a new test for drawing the line between them.

This case is concerned, of course, only with the second question. We concede that respondent's stockholding was an income-producing activity the expenses of which are deductible under § 23(a)(2); we contend only that the costs of his divorce litigation were expenses, not of that activity, but of his "personal" or "family" life and hence nondeductible under § 24(a)(1). Since, as the history shows, that is not the issue to which the language of § 23(a)(2) was directed—and since the question requires in any event not merely an application of § 23(a)(2) but an accommodation of that provision with § 24(a)(1)—it seems plain that the question cannot be resolved, as the court below sought to resolve it, by a mere literal application of the wording of § 23(a)(2). Before examining the history of § 23(a)(2) to show its limited purpose, however, it is appropriate to point out that, even if we accept the Court of Claims' premise that the answer to this case is to be found in the words of § 23(a)(2) considered apart from their history and their relationship to § 23(a)(1), the words do not in fact say what the court said they say.

A. THE COURT OF CLAIMS' DECISION IS WRONG EVEN ON A LITERAL READING OF SECTION 23(a)(2).

The Court of Claims reasoned that, since the purpose of the defense of the suit was to avoid a liability

pose of assets which in turn were income-producing, his litigation costs were literally "incurred * * * for the * * * conservation * * * of property held for the production of income" and hence deductible. Confining ourselves to the words of the statute, we will show that that apparently simple syllogism not only gives to "conservation * * * of property" an unnatural meaning but also quite ignores some other words in the statute, namely, those of § 24(a)(1).

1. The premise of the Court of Claims' reasoning is that a taxpayer's efforts to retain his ownership of property by resisting financial claims that would require him to sell it constitutes "conservation * * * of property." That requires reading "conservation" to mean the same thing as "retention" and "of property" to mean "of the taxpayer's interest in property." Neither of those substitutions is self-evident and the context suggests quite the contrary.

Property and an interest in property are quite different things, and § 23(a)(2) literally refers only to "property." Its full text, moreover, seems unavoidably to refer to operations ("management, conservation, or maintenance") performed with respect to the thing itself, the res, rather than the owner's interest in the res. Surely, for example, the expenses of renting ("managing") or repairing ("maintaining") real property held for rental purposes are within § 23(a)(2), and in that usage the thing being managed or maintained is the house itself, not the taxpayer's title to it. Thus, unless the single word "property" was used with an uncomfortable double meaning—a contention ill made by a literalist—the

expenses of protecting one's *ownership* of property (against the need to sell it to raise money to meet a financial demand) cannot be within § 23(a)(2).

The same result follows if the word "conservation" is examined. "Conservation" is defined in Webster's New International Dictionary (2d ed.) to mean:

> 1. A conserving, preserving, guarding, or protecting; a keeping in a safe or entire state; preservation.

The verb is in turn defined:

> 1. To keep in a safe or sound state; to save; to preserve from change or destruction.

As thus defined, "conservation" implies a physical safeguarding of the thing, or the prevention of change in its state. And it is in that sense that "conservation" is used in § 23(a)(2) to make deductible the cost of a night watchman to guard rental property or the fee paid for a safe deposit box in which to keep securities. To use "conservation" as including also the avoidance of the need to sell an interest in the thing to satisfy a liability not only seems a rather remarkable usage but it again requires that a single word be made to do double service.

Finally, an expense incurred for the "conservation * * * of property held for the production of income" seems to us to imply an expenditure having a direct relationship to a specific piece of property. It may be acceptable usage to refer to minimization of one's expenditures or liabilities as "conserving" one's *estate*—meaning by that his total wealth—but we deny that it is common usage to identify avoidance or minimization of general liabilities as an act of "conserv-

ing" any specific "property" held by the taxpayer, for the production of income or otherwise.

2. Secondly, a literal reading of the statute cannot stop with § 23(a)(2) but must deal with § 24(a)(1) as well. Section 24(a)(1) provides that no deduction shall "in any case" be allowed for "personal, living, or family expenses," and that literally includes the case of an expenditure otherwise literally within § 23(a)(2). Thus, if an expense of resisting a wife's assertion of rights arising from the marriage relationship were properly to be characterized (because of the origin of the claim) as a "personal" or "family" expense within the meaning of § 24(a)(1), the expense would be nondeductible even if it also qualified (because of the threatened consequences of the claim) as one incurred for the "conservation" of income-producing property within the meaning of § 23(a)(2). Even one who seeks to answer the question by a literal reading of the statute is thus ultimately forced back to defining, without further statutory aid, the word "personal" and saying what it is that distinguishes the "personal" from the "business."

3. A final objection to the Court of Claims' reading derives from its implications if applied with the same literalness in other contexts. The court reads "incurred * * * for" as referring to the consequences to be achieved by the expense: an expense is "for" conservation if making it will *result* in conservation. But what if the conservation is the cause of the expense rather than *vice versa?* An example might be the defense of a suit by a tenant for the assault and battery of a night watchman who mistook him for a

burglar.[8] The night watchman was hired for the conservation of the property, and it was his activities to that end that gave rise to the suit, but defending the suit will not itself "conserve" anything except the defendant's money. The defense costs, in short, are literally not incurred "for" the conservation of the property but only "because of" prior conservation activities. Under the Court of Claims' literal reading, therefore, they would not be deductible. It was just that sort of literalism, however, that this Court rejected long ago in *Kornhauser* v. *United States*, 276 U.S. 145, in interpreting the counterpart language of § 23(a)(1), "incurred * * * in carrying on" a trade or business. There it was argued that the expense of defending a suit arising out of a business activity could not be deducted because the defendant, at the time of suit, was no longer "in" the business giving rise to the suit and the defense costs could not, therefore, have been incurred "in carrying on" the business. This Court rightly paid no heed to the argument and held that the defense costs were to be treated as a cost of the activities from which the suit resulted. The "for" of § 23(a)(2), we submit, is no more the answer to the question in this case than was the "in" of § 23(a)(1) in the *Kornhauser* case.

This last objection, it may be seen, goes less to the particular interpretation adopted by the Court of Claims than to the attempt to give the statute such a literal interpretation at all. The language "incurred

[8] A more likely example, of course, is that of a suit for injuries resulting from a defect in the premises, but we have chosen the night watchman case to stay within the "conservation" category.

* * * for the management, conservation, or maintenance of" (§ 23(a)(2)) is no more precise or self-explanatory than the phrase "incurred * * * in carrying on" (§ 23(a)(1)), and it must ultimately be recognized that neither is anything more than an attempt to convey the notion of an expense being an expense "of" the income-producing activity. To seek more help than that from the bare language of the statute is fruitless.

B. SECTIONS 23(a)(1) AND 23(a)(2) ARE IN PARI MATERIA AND TOGETHER SERVE THE SINGLE FUNCTION OF PERMITTING DEDUCTION OF "BUSINESS" AS DISTINGUISHED FROM "PERSONAL" EXPENSES

1. Prior to 1942, the only general provision authorizing the deduction of the expenses of income-producing activities was the forerunner of § 23(a)(1), which allowed deduction only of expenses incurred in carrying on "any trade or business." Giving that provision a narrow construction, the Treasury contended that only certain kinds of profit-seeking activities constituted engaging in a "trade or business" and that there was no authority for the deduction of the expenses of other kinds of profit-seeking activities. That interpretation was ultimately upheld by this Court in a series of three decisions announced in 1941. In *Higgins* v. *Commissioner*, 312 U.S. 212, the Court, noting that not "every business transaction" constituted "carrying on" a "trade or business" (p. 217), held that the activities of an individual in overseeing his extensive investments in stocks and bonds did not constitute a "trade or business" in the statutory sense and hence that his expenses of maintaining a staffed

office to handle his investments were not deductible. The same result was reached in *City Bank Co.* v. *Helvering*, 313 U.S. 121, in denying a trust a deduction for the fee paid a trustee for its services in managing the trust fund, and in *United States* v. *Pyne*, 313 U.S. 127, as to a decedent's estate.

In the Revenue Act of 1942 (56 Stat. 798, § 121), Congress promptly responded to the "inequity" thus revealed—*i.e.*, of denying a deduction for the expenses of profit-seeking activities the income from which was taxed [9]—by adding § 23(a)(2), allowing deduction of the expenses of all income-producing activities regardless of whether the activity constitutes a technical "trade or business." The committee reports make clear that the sole purpose of the amendment was to remove the "trade or business" limitation on the kinds of profit-seeking activities the expenses of which could be deducted: [10]

> A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. * * *

That is to say, § 23(a)(2) was directed solely to the kinds of activities the expenses of which are deductible and not at all to the tests for determining whether an expenditure is an expense "of" the activity. Or, to put it another way, § 23(a)(2) removed

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[9] H. Rep. 2333, 77th Cong., 2d Sess., p. 46.

[10] H. Rep. 2333, 77th Cong., 2d Sess., p. 75; S. Rep. 1631, 77th Cong., 2d Sess., p. 88

the distinction between a "trade or business" and other kinds of income-producing activities, but it did not affect the distinction between "business" expenses (though now including those of all income-producing activities, not just of a "trade or business") and "personal" expenses. When the question is, as here, whether a claimed deduction is an expense of an income-producing activity or an expense of one's personal life, the question is the same whether the deduction is claimed under § 23(a)(1) or under § 23(a)(2).

2. The limited function of § 23(a)(2) and its relationship to § 23(a)(1) was confirmed by this Court upon its review of the history of that provision in *McDonald* v. *Commissioner*, 323 U.S. 57; *Trust of Bingham* v. *Commissioner*, 325 U.S. 365; and *Lykes* v. *United States*, 343 U.S. 118. The new provision, the Court said, was "comparable and *in pari materia* with § 23(a)(1)," providing for a class of deductions "coextensive with the business deductions allowed by § 23(a)(1), except for" the requirement that the income-producing activity qualify as a "trade or business." *Trust of Bingham, supra*, at pp. 373, 374. The purpose was to overcome the specific inequity brought to light by the *Higgins* case by enlarging "the category of incomes with reference to which expenses were deductible," but not to "enlarge the range of allowable deductions of 'business' expenses"; accordingly, if an expense was previously nondeductible, not because the income-producing activity failed to qualify as a "trade or business," but because the relationship of the expenditure to the activity was insufficient to qualify it as an expense "of" the activity, § 23(a)(2) did not

make it any more deductible. *McDonald*, *supra*, at pp. 61–62.

3. Not only do history and authority require that §§ 23(a)(1) and 23(a)(2) be given the same effect in that respect—*i.e.*, in defining the required relationship between the expense and the income-producing activity—but any other view would produce a capricious discrimination between taxpayers engaged in a "trade or business" and those engaged in other kinds of income-producing activities.

Whether § 23(a)(1) or § 23(a)(2) is technically applicable to a given case depends solely upon whether the income-producing activity involved constitutes a "trade or business" or not. In our view of the two provisions, it makes no difference which is applicable, and the distinction between a technical "trade or business" and other income-producing activities is thus effectively obliterated. Under the Court of Claims' view the distinction remains, only it is turned topsy-turvy: the fact that an income-producing activity qualifies as a "trade or business" may make an expenditure *less* deductible than if it were not a "trade or business."

That consequence may be demonstrated by supposing that in this case the respondent had conducted his dealerships as a sole proprietorship rather than in a corporate form. That would not have changed the seriousness of the threat to his income-producing assets from his wife's suit nor the causal relationship of the expense of defending the suit to the ultimate production of income. Under the Court of Claims' view, however, it would drastically change the result,

for, since a sole proprietorship is a "trade or business," the case would now be governed by § 23(a)(1) rather than § 23(a)(2). Thus the language the court found dispositive of the actual case—"incurred * * * for the management, conservation, or maintenance of" income-producing property—would no longer be controlling but would be replaced with the rather less congenial language, "incurred * * * in carrying on" a trade or business. One must assume that, since the Court of Claims found the particular wording of § 23(a)(2) so essential to its result, it would be forced to reach a different result under § 23(a)(1) and would hold that the divorce litigation costs were not deductible, not being literally an expense incurred "in carrying on" the business. In short, the deductibility of the expenses of resisting a wife's financial demands turns, in the Court of Claims' view, upon whether the husband's business is incorporated or not. And while that is anomalous enough, it is made even more anomalous by the fact that the discrimination is in favor of those whose income-producing activities *fail* to qualify as a "trade or business." The former victims of discrimination (under *Higgins*) are now to be a favored class, and all in the name of a statute expressly designed to eliminate such unjust discriminations.

That discrimination inheres, it may be seen, in any construction of the statute that relies upon the language of § 23(a)(2) ("incurred * * * for the management, conservation, or maintenance of" income-producing property) as being in some way less restrictive in scope than the corresponding language of § 23(a)(1) ("incurred * * * in carrying on" a trade or busi-

ness). It can be avoided only by recognizing that, as the history teaches, the difference in wording is attributable only to the different kinds of income-producing *activities* being described in the two provisions and was not meant to prescribe a different test for determining whether an expenditure is an expense *of* a given income-producing activity.

We have shown in this Point that the sole purpose and effect of § 23(a)(2) was to eliminate the distinction, for deduction-purposes, between a "trade or business," in the technical sense, and other income-producing activities. With the distinction between kinds of income-producing activities eliminated, §§ 23(a)(1) and 23(a)(2) can together appropriately be described as authorizing the deduction simply of all "business expenses"—*i.e.*, using "business" in a broad sense encompassing all income-producing activities, the only sense, indeed, in which it is any longer useful.[11] The

[11] The caption given to § 23(a)(2) in the Code—"Non-trade or non-business expenses"—while historically understandable, is a classic misnomer. Of the universe of expenses, the only thing it excludes is "trade or business" expenses which, being equally deductible, is the one category that it is totally unimportant to differentiate. The Code's caption, that is, serves only to distinguish § 23(a)(2) from § 23(a)(1), not from "personal" expenses or other kinds of nondeductible expenditures. Section 23(a)(2) expenses can usefully be called "non-business" expenses only if one is interested for some reason in distinguishing between the expenses of a "trade or business" in the technical sense and those of other income-producing activities, a distinction which, though the historical explanation for the usage, is no longer relevant to deductibility. For every

identity of function between §§ 23(a)(1) and 23(a)(2) means, in turn, that the question in this case turns, not upon any difference of wording between those two provisions, but upon the basic dichotomy between those two provisions ("business" expenses), on the one hand, and § 24(a)(1) ("personal" expenses), on the other.[12] The question, to which we now turn, is simply: what aspect of a litigation expense governs its characterization as "business" or "personal"?

II

THE CHARACTERIZATION AS "PERSONAL" OR "BUSINESS" OF THE COSTS OF RESISTING A CLAIM IS GOVERNED BY THE SOURCE OF THE CLAIM AND NOT BY THE CONSEQUENCES A FAILURE TO DEFEAT IT WOULD HAVE

The critical question in this case is whether the characterization as "business" or "personal" of the expenses of resisting or compromising a claim turns upon (a) the origin and nature of the claim (*i. e.*, whether the claim arises from business or personal

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other purpose—in particular, the distinction between the expenses of income production and those of one's personal life with which we are concerned here—expenses deductible under § 23(a)(1) and those deductible under § 23(a)(2) can be lumped together as a single class of "business" expenses.

[12] As we have previously suggested (p. 22, *supra*), one can arrive at the same result by saying that, whatever the initial scope of § 23(a)(2) read alone might be, § 24(a)(1) nevertheless carves it down by expressly disallowing "personal" expenses, thus making the applicability of the "personal" characterization the controlling question in any event. Sections 23(a) and 24(a)(1) are not, however, antagonistic in purpose and the same result should be reached whichever is the starting point. Rather than viewing § 23(a) as granting a deduction and § 24(a)(1) as taking it back, they should be viewed as complementary provisions and given a consistent construction.

activities) or (b) the consequences or effect a failure to defeat it would have (*i.e.*, whether an adverse judgment would expend itself upon business or personal assets). The court below, following *Baer* v. *Commissioner*, 196 F. 2d 646 (C.A. 8), and its progeny, held the consequences determinative and allowed the deduction because the wife's claims, if successful, would have caused the loss of part of respondent's stock and perhaps of his job. In our view, supported in the specific context of divorce litigation by the conflicting decision of the Second Circuit in *Lewis* v. *Commissioner*, 253 F. 2d 821, it is the nature and source of the claim that controls, and the costs of resisting asserted marital rights are thus a cost of the marriage from which the claim arose and not of the business upon the assets of which the claim, if successful, would expend itself. The issue, in short, is neither more nor less than the validity of the long-standing regulation that:

> An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.[13]

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[13] Regs. (1954 Code), § 1.212-1(m); see Regs. 118 (1939 Code), § 39.23(a)-15(k). In a sense, the validity of the specific regulation which disallows deductions for legal fees incurred in connection with divorce proceedings (see p. 45, n. 21, *infra*) is more directly at issue, but it is the general provision quoted in the text that establishes the fundamental principle of which the divorce-costs regulation is but a specific application.

We will show (1) that the rationale of the court below is indefensible in reason; (2) that it has in any event been definitively rejected by this Court; and (3) that in fact even the lower court decisions are uniform in support of the basic principle, having departed from each other only in the creation of a demonstrably untenable "exception".

A. MAKING THE DEDUCTIBILITY OF THE COSTS OF RESISTING A CLAIM TURN UPON THE NATURE OF THE ASSETS THREATENED BY THE CLAIM PRODUCES CAPRICIOUS AND IRRATIONAL RESULTS

The implications of the contending principles can be most conveniently illustrated in the context of tort litigation, where the elements of source and consequence can be most easily varied. If a taxpayer is sued, say, for $200,000 in damages for personal injuries caused in an automobile accident, the deductibility of the defense costs turns, we contend, upon whether the accident occurred in the course of a business activity (*e.g.*, while an employee was making deliveries) or a personal one (*e.g.*, a vacation trip). To make it turn, to the contrary, upon the nature of the assets the defendant owns (and thus would have to sell to pay an adverse judgment) is, we submit, wholly capricious.

1. The first objection to making the defense costs of such a suit turn upon the nature of the assets threatened by it is that the income-producing or non-income-producing nature of the assets that would be consumed by an adverse judgment simply has no causal or other rational connection either with the cause of the suit or the reasons for defending it. It is true enough that if the defendant owns nothing but a cor-

ner grocery store, a $200,000 tort suit will threaten the very existence of his business. But that fact will give him no more cause to resist the claim than if he owned nothing but a home: $200,000 is $200,000, and it is equally worth fighting to keep whatever the form in which it is invested (a home or a store). It is evident, indeed, that since assets are readily convertible from one form to another, the form in which they are held at any given time—in particular, at the time of suit—is essentially fortuitous and dependent on factors having nothing to do with the suit. Making deductibility of the defense costs turn upon the form of investment at the time of suit would mean, for example, that a home-owning defendant could become entitled to deduct the costs of defending the tort suit by mortgaging his home and investing the proceeds in government bonds before the trial began. His defense of the suit would then, in the court's terms, be for the "conservation" of income-producing property (the interest-bearing bonds) which, after being "conserved" by the successful defense of the suit, could then presumably be used to discharge the mortgage on his home. The non-sense of a rule turning upon such irrelevancies is evident. If two taxpayers have accidents while on their vacations and are sued for personal injuries, they ought both or neither be allowed to deduct the costs of defending the actions; it is offensive to reason to allow one to deduct the costs because he happens to be a store owner or a stockholder and deny a deduction to the other because his capital happens at the time to be invested in a home. Whether the property that may have to be used to satisfy the

liability happens to be income-producing or not has nothing to do with either the accident giving rise to the claim or to the taxpayer's reasons for defending it (to preserve his *assets*, whatever they may be). It should have no more to do with the tax consequences of the claim and its defense.

2. Like most tax questions, which aspect of an expense governs its characterization as "personal" or "business" cuts both ways. If the Court of Claims treats as "business" the expense of defending a suit threatening business assets, it must also, to be consistent, treat as "personal" a suit threatening only personal assets. Deduction of the cost of defending a suit for injuries caused by an employee while making deliveries would thus, for example, have to be denied if, by the time the case was tried, the defendant had sold the business, purchased a home, and retired. Since the judgment could be executed only upon the home, the expense of resisting it would be incurred for the "conservation", not of income-producing assets, but only of personal assets."

Nor can that corollary be avoided by saying that the expense is "business" if related to business *either* in origin or consequence. Not only would that require the court to abandon its "literal" reading of § 23(a)(2)—the only justification offered for the rule in the first place—but there is no warrant for giving such two-edged preference to the allowance of "business"

"To make the language of § 23(a)(2) literally applicable in this context, if that be thought important, we need only make the suit one for injuries caused by the alleged negligence of an employee hired to paint rental property which, at the time of suit, is no longer owned by the taxpayer.

expenses over the equally explicit—and literally overriding—disallowance of "personal" expenses (§24(a)(1)). The same aspect of the claim must control the characterization for both purposes, and if the fact that "business" assets are threatened makes the defense "business", the fact that "personal" assets are threatened must make the defense "personal". Taxpayers cannot have it both ways.

Once the implications of the question for the converse situation (a claim business in origin and personal in threatened consequence) are recognized, it becomes evident that one must look to the nature and source of the claim to determine for tax purposes the "business" or "personal" character of the costs of defending it. If a claim arises from a business transaction, the cost of defending it is a cost of business and deductible; if from a personal activity, it is a cost of the personal activity and nondeductible; in neither case is the content of the defendant's portfolio at the time of suit relevant.

B. THE QUESTION HAS BEEN AUTHORITATIVELY RESOLVED BY THE DECISIONS OF THIS COURT

In numerous decisions the Court has in general language emphasized the requirement of deductibility that the expense *arise out of* or be incurred *in* the profit-seeking activity. Thus, an expense which "is directly connected with or proximately results from the conduct of"—or is an "integral part of carrying out" an income-producing activity is deductible (*Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 374, 375 (expense of winding up trust)), while an expense "not incurred in 'carrying on' his 'business'" is not (*Mc-*

Donald v. *Commissioner*, 323 U.S. 57, 62 (expenses of campaign for re-election as judge)). And in terms of an expense incurred in satisfying an obligation (though not a litigation expense), the Court has specifically noted that "it is the origin of the liability out of which the expense accrues" or "the kind of transaction out of which the obligation arose * * * which * * * [is] crucial and controlling." *Deputy* v. *du Pont*, 308 U.S. 488, 494, 496.

We need not, however, rely upon the implications to be drawn from such general language, for there are two decisions of the Court, dealing specifically with litigation costs, that are in our view directly controlling: *Kornhauser* v. *United States*, 276 U.S. 145, and *Lykes* v. *United States*, 343 U.S. 118.[15] Those two cases, dealing with both of the converse situations—a claim business in origin and personal in consequence (*Kornhauser*) and one personal in origin and business in consequence (*Lykes*) establish beyond dispute that, whichever way it cuts, it is the origin rather than the consequence of the claim that controls.

1. In *Kornhauser*, the taxpayer's former law partner brought suit against him for an accounting, alleging that certain fees that had been paid to the taxpayer (in the form of stock) were for services performed during the existence of the partnership and should be divided with him. The taxpayer, having successfully defended the suit on the ground that the

[15] *Commissioner* v. *Heininger*, 320 U.S. 467, also dealt with litigation costs. There, however, the litigation both *arose from* and *threatened* the taxpayer's business, so that the distinction considered here was not involved.

fees were paid for services performed after termination of the partnership, sought to deduct the expense of the litigation. In reasoning precisely paralleling that of the Court of Claims in this case, the then Bureau of Internal Revenue argued that since the taxpayer was no longer a partner the expense was not incurred "in carrying on" a business in which he was then engaged but was simply a personal or capital expense designed to protect the taxpayer's personal property from the plaintiff's claim. Reviewing prior rulings holding deductible the expenses of defending, for example, medical malpractice suits, patent infringement suits, and suits for injuries caused by employees, the Court drew from them the principle that "where a suit or action against a taxpayer is directly connected with, or * * * proximately resulted from, his business, the expense incurred is a business expense." Agreeing that the principle was sound and "covers the present case," the Court held the litigation costs to be a "business" and not a "personal" expense (276 U.S. at 153). What *Kornhauser* holds in express terms, we submit, is that it is the nature of the activity from which the "suit or action * * * resulted," not the prospective effect of an adverse judgment, that fixes the tax character of the costs of defending it.

2. The *Kornhauser* case, involving the converse situation (business claim threatening personal assets), may be persuasive only in principle, but the *Lykes* case provides a direct holding on the very question of critical importance in this case: whether the defense of a claim arising from a personal transaction becomes

a "business" expense merely because the liability, if sustained, will have to be met out of income-producing assets.

Mr. Lykes was the president of a closely-held family corporation. From his 3,000 shares of stock, he made gifts totalling 1,000 shares to his wife and children, paying a gift tax on the transfers at a stated value. The Commissioner found the taxpayer's valuation of the stock much too low and asserted a gift tax deficiency of $145,000. Litigation of the value was ultimately settled by the payment of $15,600 in additional taxes. Mr. Lykes claimed a deduction under § 23(a)(2) for the expenses of the litigation. He argued, *inter alia*, that had the original deficiency been upheld he would have had to liquidate his remaining stockholdings, his primary source of income, in order to pay it and that, accordingly, the expense of defending the claim was an expense of conserving and maintaining his income-producing property. Noting first that the deductibility of legal fees "turns wholly upon the nature of the activities to which they relate" and that the gifts which gave rise to the claim were personal rather than income-producing transactions (343 U.S. at 123), the Court went on to reject the taxpayer's argument in terms equally dispositive of this case (343 U.S. at 125–126):

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of

liens whatever income-producing property he might have. For example, it suggests that the expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. Section 23(a)(2) has never been so interpreted by us. * * *

While the threatened deficiency assessment of nearly $156,000 added urgency to petitioner's resistance of it, neither its size nor its urgency determined its character. It related to the tax payable on petitioner's gifts * * *. The expense of contesting the amount of the deficiency was thus at all times attributable to the gifts, as such, and accordingly was not deductible.

If, as suggested, the relative size of each claim, in proportion to the income-producing resources of a defendant were to be a touchstone of the deductibility of the expense of resisting the claim, substantial uncertainty and inequity would inhere in the rule. * * * It is not a ground for defense [deduction?] that the claim, if justified, will consume income-producing property of the defendant. * * *.[16]

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[16] Expenses of contesting tax liabilities—the fact situation directly involved in *Lykes*—are now deductible under § 212(3) of the 1954 Code. That provision, new to the 1954 Code, reflects simply a policy judgment, of obvious appeal, that the expenses of litigating with one's government over tax liabilities ought to be deductible notwithstanding their "personal" character, and is of a piece with, for example, the deduction allowed for extraordinary medical expenses. It in no way detracts from the basic holding of the *Lykes* case that, for purposes of determining deductibility as a "business" expense (§ 23(a)(1) or (2)), the source of the liability rather than the nature of the assets threatened is determinative.

It would be difficult to choose language more explicitly rejecting the theory on which the decision below is expressly based—that the cost of defending a claim becomes a deductible cost of "conserving" income-producing property if the claim, undefended, would consume income-producing property. The decision of the Court of Claims can stand only if this Court overrules its *Lykes* decision and, in the process, the application of the same principle to the converse situation in *Kornhauser*.

C. THE LOWER COURT DECISIONS SUPPORT THE BASIC PRINCIPLE AND THE "EXCEPTION," SOME HAVE RECOGNIZED IS PREMISED UPON AN UNTENABLE DISTINCTION

If a husband owning diversified securities is sued by his wife for a divorce, the expenses incurred by him to resist or compromise her claims to alimony or a property settlement are not deductible notwithstanding that the wife's claims would require him to dispose of a substantial part of his portfolio of securities—*i.e.*, of his income-producing property. To that proposition there is no dissent to be found in any of the lower-court decisions. The Board of Tax Appeals so held as early as 1926;[11] the regulations

[11] *Joyce* v. *Commissioner*, 3 B.T.A. 393; *Robins* v. *Commissioner*, 8 B.T.A. 523. For an early court of appeals case accepting without question the principle that the defense is personal if the dispute arose from personal transactions (and thus examining only the question whether the dispute in fact arose from the spouses' business affairs or, as the court concluded, their domestic affairs), see *Sanderson* v. *Burnet*, 63 F. 2d 268 (C.A.D.C.).

While these cases arose before the addition of §23(a)(2) (in 1942), the same argument could be, and was, made before then on the premise that the assets threatened were assets

have so provided since 1934 (see note 21, p. 45, *infra*); and every case dealing with the deductibility of fees incurred in divorce litigation has expressly acknowledged that to be the rule. What the dispute in the lower courts is about—and all that it is about—is whether there is an "exception" to the rule.

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used in the "trade or business." That the management of a portfolio of securities was not a "trade or business" was not definitely resolved, it should be remembered, until the *Higgins* decision in 1941 (see pp. 24-25, *supra*). Thus in the formative *Loges* decision, *supra*, the Board assumed that the husband's management of his estate (stocks and bonds) was a "trade or business" and disposed of the claim in terms equally applicable to § 23(a)(2). Answering an argument that since his wife's attempt in divorce proceedings to set aside a postnuptial property agreement and obtain a larger award of property threatened his "business" assets, the expense of compromising her claims was a business expense, the Board, in language foreshadowing the *Lykes* decision (under § 23(a)(2)) by some 26 years, said (p. 397):

> * * * his purpose in entering into the [postnuptial] agreement, or in resisting the attacks upon it [*i.e.*, to preserve his estate], is not determinative of the nature of the expense. Any kind of liability to which he might have been subjected, however remote from the carrying on of his business, would have the same results to his estate. The taxpayer's argument ignores the genesis of the rights which he attempted to settle and limit by the postnuptial agreement. Whatever rights the wife had arose out of the marriage relationship, and her claims subsequent to the postnuptial agreement were certainly of the same origin. It is this fact which must determine the nature of the expense of opposing or adjusting those claims. * * *

Looking thus to the "genesis" of the rights asserted, the Board concluded that, marriage being a personal relationship, the "legal rights and obligations annexed to the relationship are also personal, and the expenses connected therewith" are thus "personal or family expenses" which are expressly made non-deductible (*ibid.*).

1. The birth of the claimed exception came in 1952 with the decision of the Eighth Circuit in *Baer* v. *Commissioner*, 196 F. 2d 646. Mr. Baer was the president of a corporation in which he owned a substantial amount of stock. His wife, suing for divorce, demanded, in satisfaction of her rights to alimony, a lump-sum payment so large that, to make it, Mr. Baer would have had to sell a considerable part of his stock, jeopardizing his control of the company and thus his position as president. Negotiations produced an agreement giving the wife, in addition to a small cash payment, the right to fixed monthly payments for the rest of her life. The agreement recited that the wife had agreed "to modify and reduce" her demands in consideration of the agreement to pay alimony regardless of remarriage. The total value of the settlement was in fact less than half the amount originally demanded.[18] Mr. Baer claimed a deduction for the part of his attorneys' fees which were for services in negotiating "the form and amount" of alimony. The Eighth Circuit, reversing the Tax Court and with Judge Woodrough dissenting, held the fees deductible under §23(a)(2). Since Mr. Baer had conceded at the outset that Mrs. Baer was entitled to "a very large sum in alimony" (though not, of course, as large as she demanded), "The controversy did not go to the question of the liability but to the manner in which

[18] The wife had demanded one-sixth of Mr. Baer's $6–$8 million estate, or something over $1 million. She got $17,500 a year for life—worth, say, $350,000 (an amount which, if invested at 5% would produce $17,500 in perpetuity)—plus $35,000 in cash and some stock worth about $50,000 (see 16 T.C. 1418).

it might be met", without causing Mr. Baer "to relinquish control of the source of his income" (pp. 649–650, 651). "[H]ence," the court said, the services were "for the purpose of conserving and maintaining this income-producing property" (p. 651).

The *Baer* case has been followed, in dictum or in holding, by the Court of Claims and the Fourth, Fifth, Sixth and Ninth Circuits.[19] Generally, their opinions have simply relied upon *Baer* as authority without adding to its reasoning, but they have to some extent clarified the boundaries of the "exception." Although the language of *Baer* distinguishing the questions of "liability" and of "manner [of payment]" is occasionally recited, most courts seem to recognize that it is a spurious distinction, since the controversy is never simply over the "manner" of payment (as it was not in *Baer*) and a dispute over the amount of liability is hardly meaningfully different from one over the fact of liability. The recognized exception seems rather to be defined solely by the threatened impact of the

[19] For holdings see, besides this case from the Court of Claims and the companion *Patrick* case (No. 22) from the Fourth Circuit: *Bowers* v. *Commissioner*, 243 F. 2d 904 (C.A. 6); *Owens* v. *Commissioner*, 273 F. 2d 251 (C.A. 5); and *McMurtry* v. *United States*, 132 F. Supp. 114 (Ct. Cls.). For dictum distinguishing *Baer* but apparently approving its holding, see *Howard* v. *Commissioner*, 202 F. 2d 28 (C.A. 3); *Tressler* v. *Commissioner*, 228 F. 2d 356 (C.A. 9); *Harris* v. *United States*, 275 F. 2d 238 (C.A. 9); *Davis* v. *United States*, 287 F. 2d 168 (Ct. Cls.), reversed on other issues, 370 U.S. 65. For cases merely distinguishing *Baer*, see *Smith's Estate* v. *Commissioner*, 208 F. 2d 349 (C.A. 3); *Richardson* v. *Commissioner*, 234 F. 2d 248 (C.A. 1). The decisions of the Second Circuit and the Tax Court expressly rejecting *Baer* are discussed at pp. 47–49, *infra*.

wife's demands and the urgency of resisting them. The distinction is drawn between demands which would merely diminish the taxpayer's portfolio of income-producing assets, on the one hand, and those which threaten "destruction" of the taxpayer's "income-earning capacity" or his "chief source of income," on the other.[20] What that category seems to mean in practice, in turn, is any case in which the taxpayer's control over an enterprise in which he is employed is jeopardized—*i.e.*, in which a loss of job as well as of assets is threatened. In short, the taxpayers in the privileged category, entitled to a deduction for divorce litigation costs denied to all others, are those who own substantial blocks of stock in corporations of which they are officers.

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[20] *E.g.*, R. 119 (where demand threatens property "without [which] the [husband] might be denied not only the property itself but the means of earning a livelihood"); *McMurtry v. United States*, 132 F. Supp. 114, 116 (where demands threaten property "control over which affects the husband's general income-earning capacity"); *Tressler v. Commissioner*, 228 F. 2d 356 (C.A. 9) (same); *Howard v. Commissioner*, 202 F. 2d 28, 30 (C.A. 9) (distinguishing *Baer* on ground that claims threatened "destruction, to a substantial extent, of his capacity to earn income"); *Smith's Estate v. Commissioner*, 208 F. 2d 349, 354 (C.A. 3) (distinguishing *Baer* as a case where claims "might force her husband to relinquish his controlling interest in a corporation of which he was president" and thus "threatened * * * the loss of his chief source of income"); *Richardson v. Commissioner*, 234 F. 2d 248, 253 (C.A. 4) (distinguishing *Baer* because claims "threaten[ed] * * * destruction of the business from which his income was derived"); *Owens v. Commissioner*, 273 F. 2d 251, 254 (C.A. 5) (threatened control of partnership business which was the taxpayer's "main hope for a livelihood").

2. The *Baer* "exception" is not only in direct conflict with the regulations[2] but it has, we submit, no rational relationship either to the principle to which it is an exception or to the statutory language it purports to apply. Diversified securities are no less "property held for the production of income" than is a controlling stock interest in a single corporation.

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[2] The present version of the regulation (Regs. (1954 Code), § 1.262-1(b)(7)) reads:

> Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

That provision derives, with various word changes over the years, from Art. 24-2 of Regs. 86, 94, and 101 (1934, 1936, and 1938 Revenue Acts) and from §§ 19.24-1, 29.24-1, and 39.24(a)-1 of, respectively, Regs. 103, 111, and 118 (all under the 1939 Code). The "Generally" qualification to the first sentence and the following "However" sentence were added in 1952 by T.D. 5889, 1952-1 Cum. Bull. 31, which expressly stated that the amendment was being made to "conform" the regulations to the decision of the Tax Court in *LeMaud* v. *Commissioner*, 13 T.C. 670. The *LeMaud* case had held that, inasmuch as Congress had in 1942 made "periodic payments" of alimony taxable as "income" to the wife (see §§ 22(k) and 23(u)), such items had to be treated as "income" for all purposes and the wife's legal expenses incurred in obtaining such taxable alimony were therefore incurred "for the production or collection of income" and hence deductible. See also the companion decision in *Gold* v. *Commissioner*, 13 T.C. 661. That history establishes that the "Generally" qualification was added specifically to allow for the single stated exception (the "However" sentence) and not otherwise to qualify the disallowance of such expenses.

and resisting a wife's marital demands has exactly the same relationship to the retention of one kind of property as of the other. If, then, litigation expenses to forestall the loss of diversified stocks do not qualify as expenses of "conserving" the stocks within the meaning of § 23(a)(2)—as *Baer* and the cases following it agree [22]—it cannot be that litigation expenses to forestall (against precisely the same kind of threat) the loss of a block of stock in one corporation can qualify as expenses of "conserving" that stock. Whatever the meaning of the word "conservation"—or of § 23(a)(2) as a whole—there is no possible basis for its having a different meaning in one context than the other.[23]

Not only are the distinctions made by *Baer* and its progeny untenable but they are of precisely the sort condemned by this Court in the *Lykes* case for the unjustified discriminations they would produce. Holding that neither the "size" of a claim nor the "urgency" of resisting it could determine its char-

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[22] Compare, in particular, the Court of Claims' own prior decision in *Davis v. United States*, 287 F. 2d 168, reversed in part on other issues, 370 U.S. 65, holding nondeductible the costs of resisting the wife's threat to stock not essential to protect the husband's employment.

[23] What is doubly curious about the *Baer* "exception" is that courts which rely so heavily on the precise wording of § 23(a)(2) ("incurred * * * for * * * conservation * * * of property") should make its application turn upon whether the taxpayer's *job* is threatened as well as his property. A job is a "trade or business," not "property held for the production of income." Any deduction premised upon the relationship of the expenditure to the taxpayer's job would have to be claimed, therefore, not under § 23(a)(2), but under § 23(a)(1). Thus, the courts that purport to find in the language of § 23(a)(2) an exception for the cost of defending claims that threaten the taxpayer's job are in fact relying on the wrong subsection.

acter, the Court noted that if "the relative size of each claim, in proportion to the income-producing resources of a defendant, were to be a touchstone of the deductibility of the expense of resisting the claim," it would produce such bizarre and discriminatory results as making the expense of defending a suit for personal injuries or alienation of affection deductible by one taxpayer who happened to own income-producing property but nondeductible by his "less well-to-do neighbor" owning none (343 U.S. at 125–126). A discrimination, in allowing deduction of the costs of resisting a wife's marital claims, between taxpayers who own substantial blocks of stock in corporations of which they are officers and all other taxpayers is, we submit, equally offensive.

3. In sharp conflict with the *Baer* decision and its followers stand the decisions of the Second Circuit in *Lewis* v. *Commissioner*, 253 F. 2d 821, and *Ditmars* v. *Commissioner*, 302 F. 2d 481.[24] In *Lewis*, the court, having concluded that the *Baer* decision was irreconcilable with *Lykes*, expressly refused to follow it and held nondeductible the taxpayer's expenses of negotiating a marital property settlement which had allegedly "conserved" his ownership of the stock of three wholly-owned corporations.

Although the *Ditmars* case—decided by the Second Circuit since the original argument of this case—does not involve marital litigation, the opinion by Judge Friendly contains an exhaustive analysis of the prin-

[24] The Tax Court, too, has remained firm. See, *e.g.*, *Douglas* v. *Commissioner*, 33 T.C. 349; *Walsh's Estate* v. *Commissioner*, 28 T.C. 1274; cf. *Rockwell* v. *Commissioner*, 37 T.C. 246.

ciples governing deductibility of litigation costs and reaffirms, in a variety of contexts, the basic principle of *Kornhauser*, *Lykes*, and *Lewis*, that the source and nature of a claim, not its threatened consequences, governs the deductibility of the costs of resisting it.[25] Of particular bearing here is the court's express application to §§ 23(a)(1) and (2) of the same tests of deductibility and its repeated emphasis that the question whether a taxpayer's litigation expense relates "to the profit-making * * * [or] to the personal side of his life" (p. 483) turns exclusively upon the source.

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[25] In a suit brought by a successor trustee, Mr. Ditmars was charged with having used his effective control over the trust, while his mother-in-law was trustee, for his or her private benefit in a variety of ways—*e.g.*, "churning" the trust's assets to earn fees for himself in his business as broker; causing the trust to purchase stock from a syndicate in which he was interested; putting the trust in the stock of a company to secure his position as president of the company; using trust assets to satisfy personal obligations; and aiding his mother-in-law in her self-dealing with the trust. The litigation was ultimately compromised for a lump-sum payment through the efforts of Mr. Ditmars' attorneys, for whose fees he claimed deductions. In holding part of the fees deductible, the court analyzed each of the activities charged to have been wrongful; classified it as a "trade or business" activity, (dealings with the trust as a broker; employment as president of corporation), an income-producing activity other than a trade or business (interest in stock syndicates), or as neither (aiding mother-in-law's self-dealing; use of trust assets for personal expenses); and held that the activity giving rise to each charge controlled the character of the expense of resisting it—*i.e.*, with the expense of the first class of activities being deductible under § 23(a)(1); of the second class, under § 23(a)(2); and of the third class, non-deductible.

of the asserted liability. The court thus observed that (p. 487):

> To such extent as litigation springs solely from the taxpayer's non-business life, expenses of defending or settling it are "personal" expenses whose deduction is forbidden by [§ 24(a)(1)] even though the litigation might be detrimental to the taxpayer's profit-seeking activities * * *.

And again (p. 488):

> * * * Any argument for deductibility under [§ 23(a)(2)], on the basis that amounts for which Ditmars might be held liable on such claims would deplete income-producing assets is foreclosed by *Lykes* v. *United States*, 343 U.S. 118. Neither can amounts paid in relation to these claims be deducted on the basis that Ditmars was attempting to forestall derogatory publicity so as to preserve his position as president of Gray.

The purpose of this point has been to establish the basic principle that the nature of litigation costs as "business" expenses (for purposes either of § 23(a)(1) or § 23(a)(2)) or as "personal" expenses (for purposes of § 24(a)(1)) must be determined by the origin and nature of the claim asserted rather than by

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As we have previously pointed out, the knife cuts both ways, and the court properly rejected for the same reasons a converse argument made by the government—namely, that no deduction should be allowed for the defense of activities in connection with the taxpayer's former business as a broker because he was *no longer* in the business and because his *motive* in compromising the case was to protect his reputation, a "personal" asset. Cf. *Kornhauser*, discussed at pp. 36-37, *supra*.

effects an adverse judgment would have. That conclusion, we have shown, is dictated by reason, the authoritative decisions of this Court in *Kornhauser* and *Lykes*, and the intrinsic force of the opinions of the Second Circuit in the *Lewis* and *Ditmars* cases. Not even the conflicting decision of the Eighth Circuit in *Baer*—though a departure in result from a rule that had been taken as settled for 26 years—purports to reject that basic principle, but even if it does, that case and those following it are irreconcilable with the *Lykes* case and cannot stand.

III

THE LITIGATION COSTS ATTRIBUTABLE TO THE CHARGES OF PERSONAL MISCONDUCT WERE CLEARLY PERSONAL AND NONDEDUCTIBLE; THOSE ATTRIBUTABLE TO DISPROVING THE CLAIMED EXISTENCE OF COMMUNITY PROPERTY WERE EITHER PERSONAL OR CAPITAL AND NONDEDUCTIBLE IN EITHER EVENT

Accepting the predicate that one must look to the source and nature of the claim to determine the character of the cost of defending it, there remains the question of characterization: which kinds of claims make the defense "personal" and which make it "business"? In many contexts—as in the case of personal injury suits, where the business or personal character of the activity causing the injury will usually be clear—that step is easy, and it poses no difficulty in the context of most divorce litigation. Certainly in common-law states, where the wife is asserting a mere *in personam* right against the husband for maintenance and support (as in the *Baer* case itself), the "personal" or "family" nature of the claim could not

be clearer and that is true whether the claim be viewed as arising from the marriage relationship itself or, more immediately, from the conduct of the husband (*e.g.*, his adultery) on which the wife's "cause of action" for divorce is based.

The community-property aspect of this case, however, introduces a complication and requires further analysis. For this purpose, it is necessary to distinguish between (a) the expenses incurred to defend the charges of respondent's misconduct made by his wife and to support the charges of her misconduct made by him, and (b) those incurred to establish that no community property existed. The former expenses—the bulk of those allowed as deductions by the Court of Claims—are, we will show, plainly nondeductible "personal" expenses. The proper characterization of the latter is more debatable but they must be treated either as "personal" or as "capital" and are in either case nondeductible.

A. THE COSTS OF LITIGATING THE MISCONDUCT CHARGES

The great bulk of the trial proceedings in the State court, which took 24 days and filled over 3,000 pages of transcript, was, as respondent acknowledges, devoted to the proof and disproof of the personal misconduct charged by each spouse against the other, charges that led the appellate court to describe the case as "one of the most sordid and revolting with which" it had ever dealt (282 P. 2d 598, 599). The Court of Claims held the costs of litigating the misconduct charges (both on offense and defense) deductible to the extent that the proof of misconduct would bear upon the division of

any community property. Under California law, if a divorce is granted for adultery or extreme cruelty, the court may divide the community property in such proportions as to it "may seem just."[2] Invoking that power, the wife claimed that, because of the respondent's mistreatment, she should be given some of his "half" of the community property. The respondent, on the other hand, claiming that the wife was at fault, in effect counter-claimed for some or all of her "half" of the community property. It was to defeat that claim of his wife's, and to establish his "counter-claim," that respondent incurred the costs of litigating the misconduct issue that were allowed by the Court of Claims.[3]

Once the source and nature of the claims is examined, it is apparent that the claims underlying the misconduct litigation were purely personal in nature. The claim of each party to an unequal division of the community property was essentially the assertion of a right to a remedy for a personal wrong—the injury done him by the misconduct of the other spouse in the course of their married life. The right the wife asserted thus arose from respondent's alleged

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[2] Cal. Civ. Code, § 146. In cases of divorces based on adultery or extreme cruelty, the court is apparently *required* to grant the innocent spouse more than half of the community property and may award all of it. See *Barham* v. *Barham*, 33 Cal. 2d 416, 202 P. 2d 289; *Wilson* v. *Wilson*, 159 Cal. App. 2d 330, 323, P. 2d 1017.

[3] The proof of misconduct went most directly, of course, to determine to which party the divorce would be awarded and to establish or defeat the wife's right to alimony, but we accept the court's 80-20 allocation as having eliminated those objects from consideration.

cruelty and his adultery, conduct having nothing to do with respondent's income-producing activities. The right he asserted against her arose, in turn, from her alleged cruelty to him. The transactions giving rise to the crossclaims for unequal division of the community property were, in short, of the most "personal" character imaginable, and so, hence, were the costs of prosecuting or defending those claims.[3]

The Court of Claims also premised deductibility of the misconduct litigation costs on the ground that respondent's defense of his wife's charges of scandalous conduct was necessary to minimize the damage to his reputation, which might have caused General Motors to cancel his corporations' franchises. That aspect, however, is answered in full by the basic principle that the origin, not the consequence, of the claim controls. If resisting a claim to avoid losing income-producing property is not deductible, *a fortiori* resisting a claim to avoid damage to reputation which might then cause a loss of income-producing property is not. See *Lewis* v. *Commissioner*, 253 F. 2d 821 (C.A. 2); *Ditmars* v. *Commissioner*, 302 F. 2d 481 (C.A. 2).

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[3] The nature of the "unequal division" aspect of the litigation might be made clearer by likening it to tort litigation. If a wife sued her husband for damages for assault and battery, and the husband counterclaimed for her assault and battery upon him, the costs of the litigation, under our analysis, would plainly be personal. Assume that, instead of a tort action, the suit, though similarly based on charges and countercharges of assault and battery, is one for divorce and an unequal division of the community property (the existence of which is conceded). Are the expenses any less personal because the remedy for the personal wrong is to be in the form of giving the wronged party part of the other spouse's "half" of the community property rather than money damages?

B. THE COSTS OF LITIGATING THE EXISTENCE OF COMMUNITY PROPERTY

The final item to be considered is the amounts spent by respondent in controverting the *existence* of community property, an issue entirely distinct from the parties' respective claims to an unequal *division* of whatever community property there was.

Under California law, earnings from personal services are community property, while gains or profits derived from separate property (*e.g.*, property owned prior to marriage) are separate property. Consequently, if, for example, a husband owns as separate property the assets of an unincorporated business to which he also devotes his services, it is necessary to allocate the earnings of the business between those attributable to his services (community property) and those attributable to his capital (separate property). This case involved an attempt to make an equivalent allocation of the retained earnings of the respondent's *incorporated* businesses.

Between the date of the marriage (1946) and the date of the divorce (1952), the net worth of respondent's corporations increased from approximately $200,000 to $800,000, the increase resulting from the retention of earnings in the corporations. Respondent's wife argued that the $600,000 of retained earnings were attributable to the respondent's services and thus impressed with a community inter-

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In the case of the two corporations in which the respondent owned less than all the stock, the computations included, of course, only the percentage of the net worth allocable to his share of the stock.

est. Since the right to the retained earnings was represented by the stock, that claim, if successful, would mean that the stock was *pro tanto* community property—in effect, treating the husband as having made a contribution to capital with community property. Respondent's defense, which he proved, was that he was paid (and devoted to community purposes) salaries that were more than generous for his services and that the large earnings of the corporations were attributable rather to their capital assets (in particular, their ownership of the Chevrolet and Pontiac franchises in the period of unprecedented demand for automobiles immediately following World War II). Mrs. Gilmore challenged, it would appear, not so much the facts as the theory of the defense, contending that as a matter of law the allocation must be made by attributing to the capital only a "fair return" on the investment and deeming all the rest of the earnings—regardless of their actual relationship to any possible value of his services—to be attributable to the respondent's personal services. The California Supreme Court, as had the trial court, upheld the respondent's theory and, approving the findings that respondent's salaries were more than ample compensation for his contributions, held that there was no community property interest in the retained earnings or, therefore, in the stock. 45 Cal. 2d 142, 149, 287 P. 2d 769, 773–774. The question here is how the costs of that part of the State litigation should be treated for tax purposes.

We do not believe the Court need now resolve that question. Unlike the expenses of litigating the mis-

conduct issues, the nondeductibility of those costs does not follow automatically from a rejection of the *Baer* doctrine and a holding that the characterization of litigation costs turns upon the nature and source of the claims asserted. For even accepting that principle, and thus looking to the nature of the wife's claim (a claim that some part of the stock was community property), there remains a thorny problem of analyzing the character of that claim and of pigeonholing as "personal," "business," or "capital" the expenses of resisting it. A decision of that issue of characterization was the object neither of the governments' petition for certiorari (to have the *Baer* case disapproved) nor of this Court's granting it (presumably to resolve the conflict with the Second Circuit over the validity of the *Baer* doctrine). Nor has that question been separately considered by the Court of Claims, which based its decision as to all the expenses on the common broad ground, the theory of the *Baer* case, that it is enough that a loss of the suit, regardless of its nature, would have resulted in a loss of income-producing property. Moreover, since the great bulk of the State litigation was over the misconduct issues,[1] the present question goes only to a

[1] See R. 132. Of the trial transcript, 2,498 pages were concerned with the misconduct allegations, 508 with the existence of community property. Of the trial court's opinion, 27 pages were devoted to the divorce and misconduct issues, only 3 lines to the community-property issue. Of the respondent's brief used in both the appellate courts, 101 pages were devoted to the misconduct and divorce issues, only 14 pages to the community-property issue. The decision of the District Court of Appeals, reversing the judgment and directing a new trial, was based entirely on the misconduct and divorce issues. 282 P. 2d

small part of the expenses for which a deduction was allowed. Under the circumstances, we suggest that should the Court agree with us on the main issues discussed in preceding portions of this brief, and thus on the necessity for reversing the judgment below at least insofar as it allowed deduction of the expenses of litigating the misconduct issues, the proper course would be to reverse the judgment and remand the case to the Court of Claims for it to consider, in the light of this Court's decision on the main issues, the proper characterization of the costs of resisting the wife's claim that part of the stock was community property. Not only is there no reason why this Court should be called upon to decide that question in the first instance, but the suggested course will also, we may note, considerably lessen the Court's burden, for we are frank to acknowledge that that question, though of relatively less importance, is of considerably greater difficulty than those considered in the previous portions of this brief.

We will, nevertheless briefly state our views of how that item should be treated, if only to indicate

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[58] Respondent's petition for rehearing, as well as his petition for a hearing in the California Supreme Court, were consequently similarly limited exclusively to those issues. Finally, less than one-quarter of the opinion of the California Supreme Court, which reinstated the trial court's judgment in favor of respondent, was devoted to the community property issue. We do not, of course, suggest that those statistics are by themselves an adequate basis for allocating the total costs, but they are indicative that only a relatively small part of the state litigation—or of the part of the costs for which a deduction was allowed—was concerned with the existence of community property.

the nature of the issue and the additional and quite different problems it raises. We will first show that the litigation cost must in any event be treated as a "capital" expenditure rather than a "current" expense of income production or of the holding of property. The question whether the litigation cost should be treated as a "personal" cost of the marriage then becomes important only in deciding whether the respondent should be allowed to add the amounts expended to the basis of his stock.

1. That §§ 23(a)(1) and 23(a)(2) alike[*] limit deductions to "current" expenses and deny deductions for "capital" expenditures is not to be doubted. The source of the limitation is usually found in the words "ordinary" or "expenses," but it is equally manifest in the references to the expenses of "carrying on," "producing," "collecting," "managing," "maintaining," or (if understood in the sense of protecting against fire, theft, etc.) "conserving." All of those terms imply, we suggest, the recurrent, regular costs of making the assets productive or of holding or carrying them over time—*i.e.*, the expenses which produce the year's income and leave the assets at year's end none the worse for it—as distinguished from the once-for-all-time expenditures that create the assets or secure for the indefinite future the ownership or use of them. Whatever the source, however, the distinction

[*] The history of § 23(a)(2) showing that there is no difference between it and § 23(a)(1) for purposes of the business-personal distinction (see pp. 24–27, *supra*) equally goes to show that there is no difference between them for purposes of the capital-ordinary distinction. See *Bowers* v. *Lumpkin*, 140 F. 2d 927 (C.A. 4), certiorari denied, 322 U.S. 755.

exists and the only problem is to apply it, an undertaking in which one looks in vain for any more precise standards than the accounting concepts of items chargeable to "capital" account and those chargeable to "current" account (cf. §113(b)(1)(A)), the statutory object to "clearly reflect income" (see §§41, 43), and the applications of those principles to particular expenditures to be found in the decisions and regulations.

The classic example of a "capital" expenditure is, of course, the cost of acquiring ownership of a capital asset, but hardly far removed from that is the cost of preserving one's ownership against a conflicting ownership claim. Thus it is that the regulations provide that (Regs. 118, §39.23(a)-15(k)):

> Expenditures incurred in defending or perfecting title to property * * * constitute a part of the cost of the property and are not deductible expenses. * * *

The rationale of that rule is evident, for the costs of retaining a capital asset against one asserting rights not themselves arising from a business transaction[4]

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[3] There is, of course, the specific provision disallowing deductions under any provision of the Code for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate" (§24(a)(2)), but that covers only a very limited class of capital expenditures and has never been read as qualifying the broader restriction implicit in the limitation of §23(a) to ordinary "expenses."

[4] We are concerned here only with an assertion of conflicting "property" rights not themselves arising from a business transaction. If the claim asserted arises from an ordinary-income business transaction, the fact that the rights asserted are in the form of a claim to property ought not bar deductibility.

have no more relationship to the current production of income or the current holding of property than do the costs of initial acquisition. Each is an outlay incurred for the right to hold the asset (and enjoy whatever income it may produce) for its useful life and is properly treated as a capital cost of securing that right, to be spread over the useful life of the asset if it is depreciable or, if not, offset against the proceeds of its later disposition.

The cost of litigating, in a divorce proceeding, whether particular assets are the husband's separate property to be retained by him or are community property to be divided with his wife would seem plainly to be a cost of defending the husband's title to the property within the meaning and rationale of

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See *Kornhauser v. United States*, 276 U.S. 145 (discussed at pp. 36-37, *supra*), where the costs of defending a suit by a former business partner for an accounting for fees received were none the less deductible because the contested fees had been received in the form of stock and the suit was thus one to establish the plaintiff's rights to a share of the stock. It should be noted, however, that the relative importance of the source as compared to the consequence of an asserted claim is not necessarily the same for purposes of making the capital-current distinction as it is for purposes of making the business-personal distinction, and it was only to the latter distinction that our earlier discussion of the *Kornhauser* case was directed.

Respondent has asserted that the difference between separate property and community property is not technically a matter of "title," apparently because of the husband's virtually unlimited powers, as manager of the community estate, to dispose even of community property. We eschew fine debates, for the regulation is concerned, not with such technical niceties of local law but with the tax treatment of the costs of retaining one's beneficial ownership of capital assets against one asserting an adverse property right, and a community property dispute is fully within any rationale to be drawn from it.

the regulations; it is a one-time cost of securing, in perpetuity, the husband's undivided ownership of a capital asset and is therefore a capital expenditure. And so the cases have held. See *Harris* v. *United States*, 275 F. 2d 238 (C.A. 9); *Shipp* v. *Commissioner*, 217 F. 2d 401 (C.A. 9), and cases there cited. *But cf.*: *Owens* v. *Commissioner*, 273 F. 2d 251 (C.A. 5). The only apparent basis for doubt is the fact that the right asserted by the wife in this case was in its nature, in State law concepts, a right to share in earnings attributable to personal services, a fact that gives to her claim something of an ordinary-income flavor. The earnings she sought to reach, however, were those retained by the corporations and she could reach them only by impressing a community-property interest upon the stock itself.[20] And notwithstanding California's willingness to pierce the corporate veil to determine the rights of the spouses *inter se*, a stockholder's interest in the assets of a corporation, retained earnings as well as contributed capital, is treated for federal tax purposes as a *capital* interest. Mrs. Gilmore's claim that a part of the stock was community property was thus an assertion of a property right in a capital asset notwithstanding that the state law theory was that the part of the stock so claimed represented earnings which, though nominally belonging to the corporations (and so treated for tax purposes), were "attributable" to the respondent's services.[20]

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[20] The capital nature of the claim would be self-evident, we suggest, if the wife's claim had been successful and the question were the proper tax treatment of her receipts. Suppose that the wife had established that $500,000 of the retained surplus of [illegible]

2. We have thus far shown that even treating the wife's claim as one of independent "property" rights, and ignoring their source in the marriage relationship, the costs of resisting them were nevertheless not currently deductible because of their "capital" nature. There remains a question—not directly involved in this case[7] but relevant to a consideration of the proper characterization of the item—whether the expenditures should be added to the basis of respondent's stock or whether the source of the wife's claim in the marriage relationship requires that they be treated as "personal" or "family" expenses and be

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the wholly-owned corporation was attributable to her husband's personal services; that that amount of retained earnings represented one-third of the net worth of the corporation; that the contribution of those services to the corporation constituted, in effect, a contribution to capital made out of community property, converting the stock of the corporation, *pro tanto*, into community property; and that one-third of the stock was accordingly community property. Had the wife been awarded, on that theory, one-sixth of the stock as her share of the community property, it is evident, we think, that her receipt would not have been treated for federal tax purposes as a receipt of earnings from personal services (and hence taxable as ordinary income). She would be treated, rather, as having merely made a nontaxable "division" with her husband of a capital asset in which they had each had an existing property interest. Cf. *United States* v. *Davis*, 370 U.S. 65, 68–71. The fact that, in creating the property interest, the state did so on a theory of protecting the wife's rights to share in the "earnings" from her husband's personal services would be irrelevant. And just as the wife would there be treated as claiming, not an income item, but an interest in a capital asset, so here the husband must be treated as seeking to retain, not income, but a capital asset.

[7] The question would arise only if and when the respondent made a taxable disposition of his stock and it became necessary to determine his capital gain or loss on the sale or other disposition.

given no tax recognition whatever. The question, in short, is whether the respondent's litigation costs are properly to be treated as a cost of his stock or as a cost of his marriage. While we acknowledge that the question is not free from doubt, it is our view that the latter is the preferable treatment.

In a common-law jurisdiction, a wife's right upon divorce to an allowance for support or maintenance or to a "share" of her husband's property is treated, not as a "property" interest, but as merely an independent personal liability of the husband to his wife. *See United States v. Davis*, 370 U.S. 65. The costs of resisting such a claimed personal liability (like the costs in this case of resisting the wife's claim to an unequal division of the community property because of misconduct) would plainly be "personal" or "family" expenses and, as such, would not only be nondeductible but could also not be added to the husband's basis. The problem here is whether the fact that a wife's rights to share in community property are deemed to be vested "property" rights makes a difference and justifies adding the cost of resisting a claim of such rights to the basis of the property.

Were the Court writing on a clean slate, we would contend that the purported "property" interest of a wife in community property is, during the marriage, so lacking in substance that it should be given no effect for tax purposes and the assertion of such rights upon divorce or death should, accordingly, be treated as an assertion not of pre-existing "property" rights but of inchoate "marital" [illegible] not significantly different in kind from those recognized in com-

mon-law jurisdictions. For present purposes, however, we will assume that such an argument is foreclosed (see, *e.g.*, *Poe* v. *Seaborn*, 282 U.S. 101; *United States* v. *Davis*, 370 U.S. 65, 69–71) and that a claim based upon the wife's "property" interest in community property is to be treated in all respects like a claim based upon any other kind of "vested" property interest. Even so, we submit, that does not govern this case, for here the dispute was not over rights flowing from an acknowledged property interest but rather over the *creation* of the property interest itself—*i.e.*, over whether the wife's inchoate "marital" right to a share of her husband's earnings from personal services ever matured into a "property" interest.

The distinction can be suggested by a case in which both questions are present. Suppose the earnings from an unincorporated business of the husband's were deposited during the marriage into a special bank account and that the wife claims (1) that, say, 70% of the business earnings were attributable to the husband's personal services and that 70% of the funds in the account were accordingly community property and (2) that some of the funds from that account were used to buy real estate owned by the husband at the time of the divorce, 70% of which is accordingly community property. The first issue, we contend, involves an assertion of an inchoate right, arising directly from the marriage relationship, to a share of the proceeds of the husband's personal services. The expenses of establishing and fixing that right—*i.e.*, of establishing the *creation* of a community-property in-

terest—are thus, we say, costs of the marriage and hence "personal." Once the community-property interest has been created (or its existence established in the litigation), however, the following of it into the real estate involves an assertion of "property" rights that can be treated as independent of their marital source.* In short, an assertion that the marital relationship gave rise to community property is an assertion of "marital" rights the defense of which is personal; an assertion that established or acknowledged community-property interests (*e.g.*, in a bank account) have given rise to another consequence (*e.g.*, to make other property traceable to the account community property) is an assertion of "property" rights, the defense of which, although capital in nature (see above), is not made "personal" by its relationship to the marriage.

The difference is perhaps less one of kind than of degree—a difference in how "proximate" the causal relationship is between the marriage and the claim and hence the defense costs. A claim that a property interest was created because of the marital status of

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* The cases holding the costs of community property litigation to be non-personal and denying their deduction only because they are capital (and thus implying a right to capitalize the costs as an addition to basis) involved disputes only of the latter category (tracing acknowledged community funds into purchased assets, or negotiating over the physical division of acknowledged community property) and are thus not inconsistent with our position here. See *Harris* v. *United States*, 275 F. 2d 238 (C.A. 9); *Shipp* v. *Commissioner*, 217 F. 2d 401 (C.A. 9). See, also, Jones, J., dissenting in *Owens* v. *Commissioner*, 273 F. 2d 251 (C.A. 5), the majority opinion of which allowed a current deduction on the authority of *Baer*.

the wife is deemed to arise "proximately" from the marriage; once the "property" interest is acknowledged or established to have been created, the causal relationship is considered to be broken and claims premised upon the acknowledged property right are not traced back to the martial origin of the property interest.

If that distinction be accepted, it would follow that the expenses here—since the dispute was whether a community-property interest ever came into being and thus involved an assertion of rights premised directly on the marriage—must be characterized as a "personal" cost of the marriage for which no tax recovery is allowable rather than as a capitalizable cost of the stock to be added to its basis. As we have noted, however, that question need not be decided in this case, for even if the cost is in some way assignable to the stock rather than to marriage it remains, as shown in paragraph 1, an expenditure capital rather than current in nature and hence nondeductible for that reason. We reemphasize, finally, that the Court need not dispose of that item of cost at all (*i.e.*, the expenses of litigating the *existence*, as distinguished from the *division*, of community property) but may properly leave the characterization of that item—involving questions quite different from those the case was brought here to resolve—to the Court of Claims on remand.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * * * *

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * * * *

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses * * * [with certain exceptions].

* * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * * *

(b) *Adjusted Basis.*—* * * *.

* * * * * * *

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, * * *.

* * * * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * * *

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, * * *.

* * * * * * *

California Civil Code, West's Annotated California Codes, Cum. Pocket Supp.:

SEC. 146. *Community Property and Homestead; Disposition on Divorce or Separate Maintenance*

Order. In case of the dissolution of the marriage by decree of a court of competent jurisdiction or in the case of judgment or decree for separate maintenance of the husband or the wife without dissolution of the marriage, the court shall make an order for disposition of the community property and the quasi-community property and for the assignment of the homestead as follows:

(a) *Community property, cases of adultery, cruelty or insanity.* If the decree is rendered on the ground of adultery, incurable insanity or extreme cruelty, the community property and quasi-community property shall be assigned to the respective parties in such proportions as the court, from all the facts of the case, and the condition of the parties may deem just.

(b) *Community property, other cases.* If the decree be rendered on any other ground than that of adultery, incurable insanity or extreme cruelty, the community property and quasi-community property shall be equally divided between the parties.

* * * * * * *

Treasury Regulations 118 (1939 Code):

SEC. 39.23 (a)-15 *Nontrade or Nonbusiness Expenses.*

* * * * * * *

(d) Except for the requirement of being incurred in connection with a trade or business, a

deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. * * *

(e) Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income * * * are not allowable as non-trade or nonbusiness expenses. * * *

* * * * * *

(k) Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees ~~is deductible~~ which is properly allocable to the services rendered in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible. Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become de-

ductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income.

* * * * *

SEC. 39.24(a)-1 *Personal and Family Expenses.*—* * * Generally, attorneys' fees paid in a suit for divorce or separate maintenance are not deductible. However, the part of an attorney's fee paid in a divorce or separate maintenance proceeding which is properly attributable to the production or collection of amounts includible in gross income under section 22(k) is deductible under section 23(a)(2). * * *

SEC. 39.24(a)-2. *Capital Expenditures.*—(a) *Expenditures except non-depreciable mine development expenditures.*—* * * The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.212-1 *Nontrade or Nonbusiness Expenses.* * * *

* * * * *

(c) Expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income * * *

are not allowable as nontrade or nonbusiness expenses. * * *

* * * * *

(BB) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. * * *

* * * * *

SEC. 1.262–1 *Personal, Living, and Family Expenses.*—(a) *In General.*—In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954, for personal, living, and family expenses.

(b) *Examples of Personal, Living, and Family Expenses.*—Personal, living, and family expenses are illustrated in the following examples:

* * * * *

(7) Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

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SEC. 1.263 (a)–2 *Examples of Capital Expenditures.*

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(e) The cost of defending or perfecting title to property.

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